

ST 97-35

Tax Type: SALES TAX

Issue: Disallowed General Deductions (No Documentation)

Sales v. Service Issues

Use Tax on Purchases, Fixed Assets, or Consumables

Use Tax on Purchases (Non-Filer) Extended Statute of
Limitation

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	
)	NO.
)	IBT
v.)	NTL
)	
TAXPAYER,)	Administrative Law Judge
)	Daniel D. Mangiamele
Taxpayer)	
)	

RECOMMENDATION FOR DISPOSITION

Appearances: Thomas H. Donohoe of McDermott, Will & Emery, for TAXPAYER; John Alshuler, Special Assistant Attorney General, for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to the taxpayer's timely protest of Notice of Liability XXXXX issued by the Department on June 26, 1992, for Retailers Occupation and related taxes covering the period July 1, 1981 to March 31, 1991. The taxpayer is an Illinois corporation engaged in the business of photoprocessing, graphic design work, and producing prints for its customer. The issue involved is whether the taxpayer sold products of photoprocessing in

conjunction with services other than photoprocessing. Following the submission of all evidence and a review of the record, it is recommended that the issue be resolved in favor of the taxpayer.

Finding of Facts:

A. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Tax Liability and correction of returns, showing a total liability due and owing in the amount of \$164,371.00 and the revised audit reducing the tax liability to \$159,960.00 including penalty and interest. Dept. Grp., Ex. No. 1, Joint Stipulation of Facts, Ex. No. 1.

B. The Department conducted a reaudit reducing the tax liability to \$159,960.00. Joint Stipulation of Facts, Ex. No. 1.

C. The parties entered into a Joint Stipulation of Facts containing the following stipulations marked as "Joint Ex. No. 1".

1. The Taxpayer is a corporation organized under the laws of the state of Illinois. Taxpayer registered with the Illinois Department under the Retailers' Occupation Tax Act and other related occupation and use tax effective September 1, 1988.

2. The Department audited the Taxpayer for compliance with the Retailers' Occupation Tax Act, Service Occupation

Tax Act and Use Tax Act for the period July 1, 1981 through March 31, 1991.

3. During the audit, Taxpayer agreed to and paid a liability for Use Tax as applied to its purchase of consumable supplies and for Service Occupation Tax totaling \$7,499 plus penalties and interest.

4. The Department also assessed \$13,629.00 in unpaid Use Tax for the purchase of certain machinery and equipment. The machinery and equipment, the purchase of which was the subject of the assessment, is listed on pages A15 and A16 of Stipulation Exhibit A (Audit Workpapers - Global Taxable Exceptions).

5. The Department also assessed \$92,260.00 in unpaid Retailers' Occupation Tax ("ROT"), Municipal Retailers' Occupation Tax ("MROT"), and Regional Transportation Authority Retailers' Occupation Tax ("RTA/ROT"). This portion of the assessment is referred to herein as the "ROT Assessment."

6. Taxpayer's business is the production of high quality graphics and signage for the display and advertising industries. Prior to September 1, 1988, Taxpayer was characterized as serviceman pursuant to the Service Occupation Tax Act. Effective September 1, 1988, pursuant to the provisions of P.A. 85-1135 under which the

sale of the products of photoprocessing at retail became subject to the application of ROT, Taxpayer was required to register as a retailer.

7. After September 1, 1988, and through the end of the audit period, Taxpayer billed, collected and remitted tax to the Department, at the combined rate for ROT, MROT and RTA/ROT required for the location of its place of business, based on 50% of the total amount set out in each invoice exclusive of amounts set out for separately stated freight charges. In collecting tax on 50% of the invoice amount, Taxpayer relied on its interpretation of 86 Ill. Admin Code Sec. 130.2000(b) which states in part:

In transactions in which products of photoprocessing are sold in conjunction with other services, if a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the selling price...

Taxpayer separately stated various charges on its sale invoices.

8. The error amount for each invoice was determined by deducting separately contracted freight charges, charges for which tax had been calculated on 50% of the amount indicated on the invoice and any charges associated with "art work" from the gross invoice charge.

9. At the time of the original audit gross sales were determined to be \$4,560.771 for the audit period September

1, 1988 through March 31, 1991. The audit sample of invoices used to extract an error rate to be applied to gross sales totaled \$85,897.00. Errors were determined to total \$24,823.00 on the 55 invoices comprising the sample. The error rate was determined to be 28.9%, arrived at by dividing \$24,823.00 by \$85,897.00.

10. In reviewing the audit, the Department agreed to reduce the error amount to \$21,841.00 by withdrawing several invoices which upon examination were determined to be sales for resale or sales in interstate commerce. The Department also reduced the error amount by taking into account evidence provide by the taxpayer substantiating certain cash discounts taken by customers. The error rate was recalculated by dividing \$21,841.00 by \$85,897.00 determined to be 25.42%.

11. The chart attached as Exhibit G sets forth invoices included in the audit sample on which the Taxpayer's customer took a discount from the stated invoice price for prompt cash payment. Additionally, invoice number 34862 should be eliminated from the audit as a sale for resale and invoice number 34696 should be eliminated as a sale in interstate commerce. The adjusted error amount of \$21,841.00 should thus be further reduced as follows:

Adjusted error finding	\$21,848
less: Invoice 34862	(555)
Invoice 34696	(60)
Cash discount error	(798)

Corrected error amount

\$20,435

The error rate is thus calculated as \$20,455.00 divided by \$85,897.00 which is 23.79%. The ROT, MROT and RTA/ROT liability asserted by the Department is thus \$75,948.00.

12. A portion of the original audit report, consisting of five pages, is attached hereto as Stipulation Exhibit B.

13. The revised audit report is attached hereto as Stipulation Exhibit C.

14. The revised audit workpapers consisting of nine pages are attached hereto as Stipulation Exhibit D.

15. The invoices forming the basis of the audit sample are listed in the Global Taxable Exceptions Report attached hereto as pages A1 through A25 of Stipulation Exhibit A. Those invoices which form the basis of the ROT liability are listed in the Global Taxable Exceptions Report and are attached hereto as pages A1, A2, A24, and A25 of Stipulation Exhibit A.

16. Copies of all invoices which comprise the sample used in determining the Taxpayer's ROT liability, consisting of 47 pages, are attached hereto as Stipulation Exhibit E.

17. Private Letter Rulings received by the Taxpayer herein from the Department dated October 13, 1988; February

9, 1989; and February 17, 1989, are attached hereto as Stipulation Exhibit F1, F2 and F3.

D. Taxpayer produced displays, cephachrome transparency graphics and back lit graphics for their customers. Tr. pp. 23-25, 32-106, Taxpayer's Ex. No. 1, 2, 3, 4, 5, 6, 8, 17, 19.

E. Taxpayer services also included checking artwork for typesetting and sizing the display proportionately. Tr. pp. 34-36

F. The quality of photographic components are checked by Taxpayer for smoothness, size, the number of colors placed into an image element, and typesetting applications as needed for its customers. Tr. pp. 36-41

G. Art time changed by Taxpayer to its customers covers the actual time for the artist to cut stats and for pasting and taping requirements. Taxpayer Ex. No. 10, Tr. p. 44

H. Taxpayer's operation contains an operation called "opaquing" which includes incorporating dust and other artifacts into the film. Taxpayer Ex. No. 11, Tr. pp. 51-52

I. Taxpayer's plant contains a mounting department which is used to hard trim, trim out an image, trim excess material from mounting boards and to laminate a customers display for protection while it is being used at the trade show. Tr. pp. 98-100

J. Taxpayer's operation includes a carpentry also shop that builds displays and shipping crates. Tr. pp. 112-113, 118, 123. Tr. pp. 112-113, 118, 123

Conclusions of Law:

The issue raised was whether Taxpayer's invoices represent sales of photoprocessing in conjunction with services other than photoprocessing.

The Retailers' Occupation Tax Act provides that a tax is imposed upon persons engaged in the business of selling at retail tangible personal property, including computer software, and including photographs, negatives, and positives that are the product of photoprocessing; but not including products of photoprocessing produced for use in motion pictures for public commercial exhibition.

35 ILCS 120/2

In addition, the statute defines photoprocessing as follows:

Sec. 2-15. Photoprocessing. For purposes of the tax imposed on photographs, negatives, and positives by this Act, "photoprocessing" includes, but is not limited to, developing films, positives, negatives, and transparencies, and tinting, coloring, making, and enlarging prints. Photoprocessing does not include color separation, typesetting, and platemaking by photographic means in the graphic arts industry and does not include any procedure, process, or activity connected with the creation of the images on the film from which the negatives, positives, or photographs are derived. The charge for in-house photoprocessing may not be less than the photoprocessor's cost price of materials. In transactions in which products of photoprocessing are sold in conjunction with other services, if a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the entire selling price unless the sale is made by a professional photographer, in which case tax is imposed on 10% of the entire selling price.

35 ILCS 120/2-15

As can be seen if charges are made for photoprocessing and are intertwined with other services, the base is 50% of the entire selling price. If charges are made exclusively for photoprocessing, tax should be calculated upon 100% of the selling price of such charges. The Department has assumed that all charges listed in Taxpayer's invoices, with minor exceptions, represent a charge for pure photoprocessing. Taxpayer has presented testimony explaining its business, emphasizing the elements of service provided its customers other than photoprocessing. Taxpayer has taken a representative invoice (Taxpayer Ex. No. 4) and explained both the service and photoprocessing involved with each statement on its invoice. I am satisfied that a significant portion of the described activities involves photoprocessing in conjunction with other services. Therefore, I find that taxpayer properly charged tax on 50% of the entire invoice.

The Department has argued that the testimony alone without some additional documentation is not sufficient to overcome the Department's *prima facie* case. The Department cites A. R. Barnes and Co. v. Department of Revenue 173 Ill. App. 3rd 826 (1st Dist. 1988) for the proposition that the testimony set forth during the hearing is insufficient to rebut the Department's *prima facie* case because no "documentary evidence associated with taxpayer's books and records" was presented. A review of the Barnes case, however, indicates merely that the Department's *prima facie* case can be overcome by Taxpayer's evidence "... which is consistent, probable, and identified with its books and records." A. R. Barnes and Co. v. Department of Revenue, 173 Ill. App. 3rd 826 (1st Dist. 1988), the Court found that

Taxpayer's explanation as to why its invoicing did not involve overcollection "taxes the credibility of the court." In other words Taxpayer's testimony involving its invoicing procedures were neither consistent nor probable. I find, however, that TAXPAYER explanation of its invoices to be consistent and probable, as well as identified with its records.

PRESIDENT, president of TAXPAYER testified as to the various services provided to customers in addition to pure photoprocessing. Specifically, he analyzed an invoice, Exhibit No. 4, to explain the specifics of the invoice and the work performed with respect to each item specified on the invoice. (Tr. pp. 100-103) Based upon this explanation, I believe each item described on the invoice involved extensive service in conjunction with photoprocessing but not separately stated. The same holds true for the other invoices Taxpayer presented. I find the service aspect of Taxpayer's work is substantiated by the testimony of WITNESS, owner of CUSTOMER, Inc., a customer of Taxpayer who testified that services are performed for his company in conjunction with photoprocessing. Tr. pp. 149-155

The testimony, both by PRESIDENT and WITNESS, represents a consistent, explanation of the work performed for customers as well as the invoices presented in connection with the work. These invoices are identified with books and records in that there is no question that the amounts on the invoices corresponds to Taxpayer's records. The only issue is whether tax should be calculated on 50% of the invoice or 100% of the invoice. Taxpayer's evidence is sufficient to show that services are rendered in conjunction with photoprocessing

and that each statement provided on the invoice represents activity that involves services in conjunction with photoprocessing. I find Taxpayer in this matter correctly used 50% as the tax base for his billing.

Based on the above testimony and documentation submitted, I recommend the assessment contained herein be cancelled in its entirety.

Daniel D. Mangiamele
Administrative Law Judge